UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

I-SYSTEMS, INC. and JEREMY KAHN,

Plaintiffs,

v.

SOFTWARES, INC., QUANTUM MANAGEMENT SYSTEMS, LLC, and CHRIST'S HOUSEHOLD OF FAITH, INC.

Defendants.

Civil No. 02-1951 (JRT/FLN)

MEMORANDUM OPINION AND ORDER ON DEFENDANTS' MOTIONS FOR SUMMARY JUDGMENT AND BIFURCATION

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Plaintiffs i-Systems and Jeremy Kahn (collectively, "plaintiffs") have brought this action against defendants Softwares, Inc. ("Softwares"), Quantum Management Systems, LLC ("Quantum"), and Christ's Household of Faith, Inc. ("CHOF") (collectively, "defendants") alleging breach of contract, copyright infringement, breach of implied covenant, breach of fiduciary duty, misappropriation of trade secrets, fraudulent transfer, deceptive trade practices, disregard of corporate entity, and conspiracy. Defendants move for summary judgment on each of i-Systems' claims. Quantum and CHOF also move for bifurcation of this matter. For the following reasons, the Court grants in part and denies in part defendants' motion for summary judgment, and denies the motion for bifurcation.

BACKGROUND

Intuitive Systems Inc. ("ISI") was incorporated as a Minnesota company in 1992 with Kahn as its sole shareholder. ISI was administratively dissolved on July 29, 1996 by the state of Minnesota for failure to file annual registration fees. i-Systems was first incorporated in Maryland in early 1996, again with Kahn as the sole shareholder and employee.[1] The state of Maryland forfeited i-Systems' corporate existence on October 4, 1996. According to Kahn, i-Systems was registered in Quebec, Canada in 1998 and then incorporated in Quebec in March 2003.

CHOF is a Minnesota non-profit corporation that during the early and mid-90s did some business under the name Soft Wares. In 1997, Softwares, Inc. was incorporated in Minnesota with CHOF as its sole shareholder. Softwares, Inc. was reorganized into Softwares, LLC, and Softwares, Inc. dissolved on or about September 30, 1998. All of

[1] During the motion hearing and in their papers, defendants referred to this company as "ISI Maryland". The State of Maryland Department of Assessments and Taxation, however, refers to "I-Systems, Inc.," and the Court will do the same.

Softwares, Inc.'s assets were assigned to Softwares, LLC on October 1.[2] On January 31, 2002, Quantum, LLC was organized in Minnesota, also with CHOF as its sole shareholder.

In September 1993, ISI entered into a Development Agreement with CHOF d/b/a Soft Wares, which provided that Kahn would develop a software product that CHOF would market and distribute. The software product, eventually named TQ Tracker, was intended, among other things, to allow companies in the prepress industry to track production and expenses, identify trends and analyze profitability.[3] Under the 1993 Development Agreement, ISI "retain[ed] all proprietary rights to the intellectual property represent[ed] by the [TQ Tracker]." The 1993 Agreement anticipated completion of the project no later than April 1, 1994. However, TQ Tracker was not completed on schedule and on April 23, 1996, ISI and CHOF d/b/a Soft Wares entered into a new Development Agreement that superceded the 1993 Agreement.

Under the 1996 Agreement, ISI again retained ownership of TQ Tracker, and CHOF d/b/a Soft Wares was the exclusive worldwide distributor of the product. In contrast to the 1993 Agreement, the 1996 Agreement also provided that in the event that certain breaches occurred, SoftWares would be granted an "irrevocable, worldwide,

[2] Softwares, LLC is appearing in this case on behalf of its predecessor in interest, Softwares, Inc. The Court will refer to both as "Softwares."

[3] "Prepress" refers to the time after printing services are purchased and before actual printing occurs during which the material is developed to the customer's specifications.

perpetual license to use, and sublicense [TQ Tracker]."[4] Under the 1996 Agreement, plaintiffs provided individual copies of the software to defendants, who then sublicensed the individual copies to end-users.

The first sale of TQ Tracker was made in late 1996 or early 1997. At least two upgraded versions were subsequently released. According to i-Systems, each version came "bundled" with a license (respectively, the "1995 license," "1998 license," and "2001 license").[5] The terms of the licenses explained that the user had purchased a license to use the software, but not ownership of the software, and that the software was protected by copyright. The customer could use the software and make a backup copy,

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[4] Specifically, the Agreement provides in relevant part:

> 2. Development. ISI agrees to use commercially reasonable efforts to (a) develop further the Product pursuant to the specifications and directives of SoftWares, and (b) meet any reasonable deadlines requested by SoftWares for completion of such additional development. ISI shall provide to SoftWares a log of all hours spent on the development work requested by Softwares and will not spend more than a commercially reasonable amount of time on development projects requested by SoftWares. During the term of this agreement, at no additional cost to SoftWares, ISI Agrees to provide the development services set forth in this section 2 for that period of time which is equal to the product of (i) 3% of gross license fees received by SoftWares resulting from the sublicensing of the Products divided by (ii) 75. SoftWares shall not require ISI to spend in excess of 30 hours per week on continued development.
>
> 10. Ownership of Product
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> a. If ISI through Jeremy Kahn or Jeremy Kahn individually fails to meet its development obligations under Section 2 of this Agreement, then ISI shall promptly grant SoftWares an irrevocable, worldwide, perpetual license to use, and sublicense the Product as SoftWares deems appropriate, in its sole discretion. Upon the grant of such license, SoftWares shall no longer be obligated to pay ISI any license fee under Section 4 hereof.

[5] The terms of the 1995, 1998, and 2001 licenses are identical. The only differences reflect the change of corporate name from ISI to i-Systems, and extend the copyright date.

but could not “reverse engineer, modify, or create derivative works based upon the software,” disclose any confidential information related to the software, or conduct any competitive business activity. The 1995 and 1998 licenses were contained in separate computer files that installed automatically when the TQ Tracker software was installed. The license stated “By installing or using this software, the individual or entity licensing the product (“licensee”) is consenting to be bound by and is becoming a party to this agreement. If licensee does not agree to all of the terms of this agreement, licensee must not install or use the software.” The 2001 license also installed automatically with the TQ Tracker software, but required the user to click through a series of screens accepting the terms of the license before using the software.

According to defendants, Kahn failed to produce a satisfactory version of TQ Tracker, and customers running the flawed versions of the product became increasingly unhappy. In early 2000, Softwares began to consider development of a new software product to replace TQ Tracker. A Softwares employee, Roderick Bley, underwent training in Rational Unified Process, an industry standard methodology for developing software, and then did significant research and planning towards development of the replacement software. Most importantly, Bley wrote a very detailed document, referred to as the Use Report, describing the desired software. In May 2001, Bley met with Claus Priisholm, a programmer. Shortly thereafter, Softwares hired Priisholm to actually program the new software based on Bley’s Use Report. The new software was eventually named Quantum MIS.

Softwares created a focus group for purposes of developing the Quantum MIS software. Softwares invited 9 TQ Tracker users to participate in the focus group, which met several times in a 4-5 month period. In at least one meeting of the focus group, Softwares referred to TQ Tracker as unstable and having speed issues. By fall of 2001, Softwares had substantially completed work on Quantum MIS, and had begun marketing it. On at least one occasion, Softwares advertised Quantum MIS as an upgrade of TQ Tracker. Softwares also offered TQ Tracker users free training on Quantum MIS. When Kahn discovered that Softwares was marketing Quantum MIS, he terminated Softwares' exclusive distributorship of TQ Tracker.

Plaintiffs filed suit against defendants alleging breach of contract, copyright infringement, breach of implied covenant, breach of fiduciary duty, misappropriation of trade secrets, fraudulent transfer, deceptive trade practices, disregard of corporate entity, and conspiracy.[6]

ANALYSIS

I. SUMMARY JUDGMENT STANDARD OF REVIEW

Rule 56(c) of the Federal Rules of Civil Procedure provides that summary judgment "shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a

[6] Initially plaintiffs also brought a claim under the Minnesota Consumer Fraud Act. Plaintiffs have withdrawn that claim, and the Court will accordingly dismiss it. Defendants have brought multiple counterclaims, which are not at issue at this time.

judgment as a matter of law." Only disputes over facts that might affect the outcome of the suit under the governing substantive law will properly preclude the entry of summary judgment. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986). Summary judgment is not appropriate if the dispute about a material fact is genuine, that is, if the evidence is such that a reasonable jury could return a verdict for the nonmoving party. *Id.* Summary judgment is to be granted only where the evidence is such that no reasonable jury could return a verdict for the nonmoving party. *Id*.

The moving party bears the burden of bringing forward sufficient evidence to establish that there are no genuine issues of material fact and that the movant is entitled to judgment as a matter of law. *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986). The nonmoving party is entitled to the benefit of all reasonable inferences to be drawn from the underlying facts in the record. *Vette Co. v. Aetna Casualty & Surety Co.*, 612 F.2d 1076, 1077 (8th Cir. 1980). However, the nonmoving party may not merely rest upon allegations or denials in its pleadings, but it must set forth specific facts by affidavits or otherwise showing that there is a genuine issue for trial. *Forrest v. Kraft Foods, Inc.*, 285 F.3d 688, 691 (8th Cir. 2002).

II. STANDING

As an initial matter, defendants assert that i-Systems Canada does not have standing to bring any of these claims because it was not formed until after this lawsuit was filed. Defendants also assert that i-Systems Canada is not a party to either the 1993 or 1996 Development Agreements, is not a holder of any relevant copyright, and does not own any of the alleged trade secrets at issue in this case. Plaintiffs respond that i-Systems Canada is a successor in interest to ISI and i-Systems Maryland, regardless of how or when those corporations were dissolved. Upon dissolution, all assets, rights and obligations reverted to Kahn as the sole shareholder and director. At that point, Kahn was operating, by default, as a sole proprietorship. Kahn then could, and did, transfer any and all of those assets, rights and obligations to i-Systems Canada whenever it was organized.

The Court agrees with plaintiffs. As noted above, ISI was administratively dissolved on July 29, 1996 pursuant to Minn. Stat. § 302A.821, subd. 4. In the case of an involuntary dissolution, once costs, expenses, debts, obligations, and liabilities of the corporation are paid, any remaining assets are distributed to the shareholders. *See* Minn. Stat. § 302A.763. Maryland law is similar. *See* MD CODE ANN. CORPS. & ASS'NS § 5-208. In this case, Kahn was ISI's only shareholder. Thus, upon dissolution, any assets of ISI reverted to him. Kahn continued functioning as ISI, although he no longer had corporate status. On September 26, 1997, Kahn, on behalf of ISI, assigned all of ISI's rights in and to TQ Tracker to "isystems, inc., a Minnesota corporation." The Court has found no record of a Minnesota corporation of this or any similar name. Thus, the assignment was ineffective, and those rights remained with Kahn. Kahn represents that any rights and property he retained were transferred to i-Systems Maryland. Upon dissolution of i-Systems Maryland, those rights again reverted to Kahn. Kahn was then free to assign those rights to i-Systems Canada. In short, despite the confusing and less than tidy corporate history of ISI/i-Systems, the Court is satisfied that i-Systems Canada and, its sole shareholder and director Kahn, have standing to sue in this case.

Further, in the event that i-Systems Canada and Kahn do not have standing to bring this action or any of the claims, the Court finds that Softwares is estopped from raising such a defense. Estoppel is an equitable doctrine that is intended to prevent a party from "taking unconscionable advantage of his own wrong by asserting his strict legal rights." *Mut. Serv. Life Ins. Co. v. Galaxy Builders, Inc.*, 435 N.W.2d 136, 140 (Minn. Ct. App. 1989) (citation and quotation omitted). Estoppel is properly applied where (1) promises were made; (2) the party seeking to invoke estoppel reasonably relied upon the promises; and, (3) the party seeking to invoke estoppel will be harmed if the doctrine is not applied. *Hydra-Mac, Inc. v. Onan Corp.*, 450 N.W.2d 913, 919 (Minn. 1990). It is undisputed that, regardless of the corporate status of either party, Kahn and defendants entered into agreements and did business with each other from 1993 through early 2002. Kahn, relying on those agreements, at least partially performed his obligations under the agreements. Accepting plaintiff's allegations as true, Kahn and I-Systems Canada will be harmed if defendants are permitted to dispose of this action solely on the ground that Kahn's various corporate entities were improperly formed and maintained.

III. BREACH OF CONTRACT – COUNT 1

Plaintiffs allege that defendants breached the 1996 Development Agreement and the 1995, 1998, and 2001 licenses that were bundled with the various versions of TQ

Tracker. Specifically, plaintiffs assert that “Softwares has failed to pay all license fees owed to i-Systems for each sublicense of TQ Tracker” in violation of the 1996 Agreement. Additionally, defendants violated the license terms by allegedly reverse engineering, modifying, or creating derivative works, namely Quantum MIS, based on TQ Tracker and planning and organizing a “business which would directly or indirectly compete” with that of i-Systems.

Under Minnesota law, a breach of contract claim consists of four elements: (1) a valid contract; (2) performance by plaintiff of any conditions precedent; (3) a material breach of the contract by defendant; and (4) damages. *Parkhill v. Minnesota Mut. Life Ins. Co.*, 174 F. Supp. 2d 951, 961 (D. Minn. 2000) (citing *Briggs Trans. Co. v. Ranzenberger*, 217 N.W.2d 198, 200 (Minn. 1970); *Boatwright Construction, Inc. v. Kemrich Knolls*, 238 N.W.2d 606, 607 (Minn. 1976) (breach must be material)). The Court will first address the 1996 Agreement, and then the licenses.

A. **1996 Agreement**

Initially, defendants assert that they not only made any payments required under the 1996 Agreement, but made overpayments of approximately $76,000. The Court does not have sufficient factual information to accept or reject defendants’ contention, and summary judgment therefore cannot be granted on this basis.

Defendants also contend that they could not have breached the 1996 Agreement because i-Systems materially breached the 1996 Agreement first, resulting in defendants receiving a perpetual license to use TQ Tracker in any way they chose.[7] Defendants allege that Kahn failed to use commercially reasonable efforts to develop TQ Tracker, failed to meet deadlines, and failed to provide a log of hours spent on the project. Under the 1996 Agreement, any of these failures would result in defendants being granted "an irrevocable, worldwide, perpetual license to use, and sublicense" TQ Tracker with no further "obligat[ion] to pay ISI any license fee." As discussed in more detail in section III(B), the Court is not persuaded that a "perpetual license to use" TQ Tracker can be understood as including a right to copy TQ Tracker. However, even if it could be so understood, the Court cannot determine that Kahn breached the 1996 Agreement so as to trigger that penalty.

The basic elements of a contract are offer, acceptance, and consideration. *S O Designs USA, Inc. v. Rollerblade, Inc.*, 620 N.W.2d 48, 53 (Minn. Ct. App. 2002). The 1996 Agreement offered Kahn compensation, which he accepted, to create a software program. The 1996 Agreement thus constitutes a valid contract that, if breached, could result in the penalties provided for. The Court finds that there are genuine issues of material fact concerning whether Kahn materially breached the 1996 Agreement by failing to use "commercially reasonable efforts," failing to meet deadlines, or failing to submit a log.

Kahn asserts that "commercially reasonable efforts" was defined in the 1996 Agreement as 30 hours of work per week. He further claims that he spent at least that much time working on TQ Tracker on a weekly basis. Defendants, however, assert that

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[7] *See* note 4, *supra*.

Kahn efforts were not reasonable in that they did not result in a finished, working product. Defendants also point out that there is no evidence in the record, other than Kahn's statements, as to how many hours Kahn actually devoted to the product. The 1996 Agreement requires ISI to use commercially reasonable efforts to develop the product and meet reasonable deadlines. It further provides that ISI shall not be required to spend more than 30 hours per week on the product's development.[8] While 30 hours of work per week may be part of the definition of "commercially reasonable efforts," the Court cannot determine from the language of the Agreement or the evidence before it that 30 hours per week is the entire definition. This question, and whether Kahn's efforts satisfy whatever definition of "commercially reasonable efforts" is established, remain material questions of fact.

Defendants also contend that Kahn failed to meet multiple deadlines. Kahn contends that he performed as required. Defendants have submitted a timeline of major events during the development of TQ Tracker. However, defendants have not demonstrated that any of those dates were agreed upon, reasonable deadlines. The evidence before the Court also does not establish that Kahn failed to use reasonable efforts to meet any deadlines, or that he in fact missed any established deadlines.

Additionally, although there is no evidence before the Court that Kahn submitted a log of his work hours to defendants, the Court finds that such a failure, without more, cannot constitute a material breach of the Agreement. To find otherwise would permit a substantial penalty to attach to an administrative error, even where Kahn had, in fact,

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[8] *See* note 4, *supra*.

totally complied with his obligations under the Agreement. While the language of the agreement could be read in this way, it can just as easily be read to require Kahn to provide a log as **backup** for the material obligation to use commercially reasonable efforts to develop the product and meet deadlines.

B. Licenses

Softwares also contends that Kahn's/i-System's breach of the 1996 Agreement relieved them of any duties under the licenses by granting it the "right to use TQ Tracker anyway it wishes," including in contravention of the licenses. The Court disagrees. In the event that Kahn is found to have breached the 1996 Agreement, resulting in Softwares receiving an irrevocable license to use and sublicense TQ Tracker, it is clear to the Court that such a license does not include the right to copy TQ Tracker, create a new competing product, or use TQ Tracker in "any" other way Softwares wishes. The Court finds that the "perpetual license" contemplated in the 1996 Agreement granted Softwares the right to download TQ Tracker, use it in its own businesses for the purpose for which it was designed, and license its use by other businesses without paying Kahn or i-Systems any further fees, but not more.

Defendants also argue that they are not and never were bound by any of the licenses because the licenses are not agreed to modifications of the 1993 and 1996 Agreements. The 1993 and 1996 Agreements both specify that each "represents, constitutes and expresses the entire agreement between the parties with respect to the subject matter" and can only be modified in writing, signed by both parties. The Court is not persuaded. The 1993 and 1996 Agreements also provide that "ISI shall retain all proprietary rights" to TQ Tracker, and grant exclusive distributorship rights to Softwares. The 1996 Agreement explicitly discusses licensing and sublicensing of TQ Tracker. A jury could find that given this explicit division of proprietary and distributorship rights, the Agreements necessarily contemplated and included licenses bridging the two sets of rights. Alternatively, the licenses could be viewed as new and separate agreements to which both parties agreed.

Defendants also contend that they were not aware of and never accepted any version of the license. A license is a form of contract and is objectionable on grounds applicable to contracts in general. *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447, 1450 (7th Cir. 1996). By the terms of the license, installation and use of the software with the license attached constituted acceptance of the 1995 and 1998 license terms. The 1995 and 1998 licenses were "bundled" with the software, meaning that a file was installed along with the software containing a license document instructing users that by using the software they were accepting the license terms. Such a license is known as a "shrinkwrap" license. The 2001 license required users to accept the terms by clicking through a series of screens before they could access the software.[9] This type of license is known as a "click-wrap" license. Courts have found both types of licenses valid and

[9] Defendants advised their sublicensees who were installing the 2001 version as an upgrade to accept the license in order to install the software, but to send in written rejections of the license. Apparently, most end-users were not aware that i-Systems owned the software rather than defendants. The 2001 license is different from that provided by defendants to end-users which seemingly caused users great concern. Since none of the end-users are party to this case, the question seems to be whether defendants were required to accept the license terms before they could turn around and sublicense the piece of software.

enforceable. *See ProCD*, 86 F.3d at 1449 (shrinkwrap); *Adobe Sys., Inc. v. Stargate Software, Inc.*, 216 F. Supp. 2d 1051 (N.D. Cal. 2002) (shrinkwrap); *I.Lan Sys., Inc. v. Netscout Serv. Level Corp.*, 183 F. Supp. 2d 328, 338 (D. Mass. 2002) (click-wrap); *Peerless Wall & Window Coverings, Inc. v. Synchronics, Inc.*, 85 F. Supp. 2d 519, 527 (W.D. Pa. 2000) (shrinkwrap); *Forrest v. Verizon Communications, Inc.*, 805 A.2d 1007 (D.C. 2002) (click-wrap); *Caspi v. Microsoft Network, LLC*, 732 A.2d 528 (N.J. App. Div. 1999) (click-wrap); *but see Specht v. Netscape Communications, Corp.*, 306 F.3d 17 (2d Cir. 2002) (rejecting click-wrap); *Comb v. Paypal, Inc.*, 218 F. Supp. 2d 1165, 1169 (N.D. Cal. 2002) (click-wrap invalid contract of adhesion).

Plaintiffs contend that by not returning the software with a 1995 or 1998 license, and by clicking through the 2001 license, defendants accepted the terms of the license and are bound by it. Defendants argue that they were unaware of the 1995 and 1998 licenses and only "accepted" the 2001 license under protest because they needed the updated software that came with it. Defendants also assert that at least some copies of the TQ Tracker software did not contain the license.

As noted above, the 1993 Agreement made it clear that Softwares did not own TQ Tracker, potentially implying that Softwares only received licenses. *See Adobe*, 216 F. Supp. 2d 1051. The 1996 Agreement explicitly refers to licenses. Further, invoices that Softwares received from plaintiffs directed recipients to "read the software license agreement ("license") carefully." Regardless of its protestations, Softwares nevertheless clicked acceptance of the 2001 Agreement. From these facts, a jury could conclude that

Softwares was aware of and accepted all three of the licenses, and that defendants are therefore liable for any breach of the license terms.

C. Conclusion

The Court thus finds that there are multiple questions of material fact as to whether defendants are liable for breach of the 1993 and 1996 Agreements and the 1995, 1998 and 2001 licenses. Summary judgment is therefore inappropriate on this claim.

IV. COPYRIGHT INFRINGEMENT – COUNT 2

In order to prevail on a claim of copyright infringement, a plaintiff must prove: (1) ownership of a valid copyright; and (2) that original elements of the work were copied. *Feist Pubs., Inc. v. Rural Tel. Serv. Co.,* 499 U.S. 340, 361 (1991); *Moore v. Columbia Pictures Indus., Inc.*, 972 F.2d 939, 941 (8th Cir. 1992). Defendants assert that i-Systems' copyright infringement claim must fail because i-Systems cannot demonstrate either required element.

A. Valid Copyright

In order to establish ownership of a valid copyright, a plaintiff must prove that his work, as a whole, is original and can be copyrighted, and that he has complied with all applicable statutory formalities. *Thimbleberries, Inc. v. C & F Enterprises, Inc.*, 142 F. Supp. 2d 1132, 1137 (D. Minn. 2001) (citation omitted). A certificate of copyright registration creates a rebuttable presumption of a valid copyright. *Id.*; *see also* 17 U.S.C. § 410(c). Evidence that the plaintiff delayed registration is sufficient to rebut the presumption. *Thimbleberries*, 142 F. Supp. 2d at 1137. Where the defendant has effectively rebutted the presumption of validity, the court has discretion to decide what evidentiary weight to accord the registration certificate in judging whether the plaintiff has established the requisite originality and protectability of the work. *Id.* (citing *Moore*, 972 F.2d at 941-42).

In this case, i-Systems has submitted a copyright registration for TQ Tracker dated June 10, 2002. In deposition, Kahn testified that TQ Tracker was a complete product by May 30, 1995. In his copyright registration application, Kahn asserted that TQ Tracker was a complete product as of January 1, 1997. Regardless of which date the Court looks to, there was a substantial delay between completion of the product and copyright registration.

A work is considered original if it was independently created, and possessed at least some degree of creativity. *Feist*, 499 U.S. at 345. Defendants argue that Kahn did not independently create TQ Tracker because he took "direction and instruction" from Softwares and an affiliated prepress company, The Electronic Easel," regarding the prepress process and that industry's needs for any potential software product. Indeed, defendants assert that "Softwares and its customers provided the primary creative input behind feature sets and functionalities for TQ Tracker."

As an outsider to the prepress industry, Kahn obviously had to do some research into the business in order to develop a program that would be useful to that industry. It is only natural that he would turn to Softwares, his business partner, and its affiliate for that information. Nevertheless, the combination and transformation of that information into a working software application required expertise and creativity that only he was able to provide to the project. Indeed, defendants concede that Kahn is entitled to claim that he independently created TQ Tracker's "literal" elements – the source code and binary object code. The Court is satisfied that Kahn's registration certificate and the evidence of his unique participation in the development of TQ Tracker are sufficient to support Kahn's copyright of the product.[10]

B. Copying

Where a valid copyright has been established, a plaintiff must then demonstrate that the defendant unlawfully appropriated, or copied, protected portions of the copyrighted work. *Feist*, 499 U.S. at 361. The Court considers two questions: (1) whether the defendant, as a factual matter, copied portions of the plaintiff's program; and (2) whether, as a mixed issue of fact and law, those elements of the program that have been copied are protected expression and of such importance to the copied work that the appropriation is actionable. *Control Data Systems, Inc. v. Infoware, Inc.*, 903 F. Supp. 1316, 1320 (D. Minn. 1995) (citing *Gates Rubber Co. v. Bando Chem. Indus., Ltd.*, 9 F.3d 823, 832 (10th Cir. 1993).

Direct evidence of copying is rarely available, and plaintiffs generally must offer indirect evidence to show that the defendant had access to the copyrighted material and that there are substantial or "probative" similarities between the accused work and the

[10] It may be that the copyright would be more properly shared by Kahn and Softwares. However, the 1996 Agreement specifies that Kahn would retain all intellectual property rights to the product and thus does not contemplate such a shared copyright.

copyrighted work. *Id.*; *Thimbleberries*, 142 F. Supp. 2d at 1139. "Ultimately, to prove factual copying, the plaintiff must come forward with sufficient evidence that a reasonable factfinder, taking together the evidence of access and the similarities between the programs, could find that the second work was copied from the first." *Gates Rubber*, 9 F.3d at 833.

Plaintiffs agree that there is no direct evidence that defendants copied lines of TQ Tracker source code or object code into Quantum MIS or that defendants reverse engineered or decompiled TQ Tracker. Plaintiffs contend, however, that there is sufficient evidence to establish that defendants had access to TQ Tracker, and that Quantum MIS is substantially similar to TQ Tracker. The Court agrees.

1. Access

Defendants concede that they had access to the non-literal elements of TQ Tracker, *i.e.* the algorithms, data structures, modules, program structures or architecture, but argue that they did not have access to the entire source code or object code. Plaintiffs contend that access to the code is established by the fact that defendants were the exclusive marketers and distributors, as well as licensee-users, of TQ Tracker. Defendants also had copies of small portions of the source code. Additionally, plaintiffs have presented evidence that Softwares' employee, Bley, regularly worked with Kahn to respond to customers and improve the operation of the program and had substantial access to the object code and all of TQ Tracker's functionality. Finally, the chief programmer of Quantum MIS, Claus Priisholm, had at least some experience with TQ

Tracker, and, as part of his research for Quantum MIS, spent an afternoon observing a business that at that time was using TQ Tracker. Such evidence is sufficient to establish that the defendant had "an opportunity to view or to copy" TQ Tracker, and therefore had access. *See Control Data Systems*, 903 F. Supp. at 1321 (quoting *Moore*, 972 F.2d at 942); *see also SAS Institute, Inc. v. S & H Computer Systems, Inc.*, 605 F. Supp. 816 (M.D. Tenn. 1985).

2. Substantial Similarities

One of the first comprehensive discussions of whether and to what extent a computer program was copyrightable is found in the Third Circuit's opinion in *Whelan Associates, Inc. v. Jaslow Dental Laboratory, Inc.*, 797 F.2d 1222 (3rd Cir. 1986). *Whelan* recognized that computer programs are generally created in stages, beginning with identification of the purpose or goal of the program, continuing to outline generally the steps that the program should follow to accomplish that goal, and then elaborating on each of those steps in increasing detail until the source code is written in a computer language and then compiled into object code. 797 F.2d at 1229-31. The court determined that the non-literal elements of a computer program, such as the structure, sequence, and organization, may, but do not necessarily, merit copyright protection. Applying long-standing copyright principles, the court found that ideas incorporated into a computer program are not protectable, but that expressions of an idea are protectable. *Whelan*, 797 F.2d at 1234-36 (discussing and applying *Baker v. Selden*, 101 U.S. 99 (1879)). The court attempted to enunciate a standard by which to divide idea from expression, stating "[t]he purpose or function of a utilitarian work would be the work's idea, and everything that is not necessary to that purpose or function would be part of the expression of the idea. Where there are various means of achieving the desired purpose, then the particular means chosen is not necessary to the purpose; hence, there is expression, not idea." *Id.* at 1236 (internal citation omitted)

Several years later, the Second Circuit, in *Computer Associates Int'l, Inc. v. Altai, Inc.*, recognized the basic process described in *Whelan* and agreed with its basic holdings. 982 F.2d at 702 (non-literal structures of computer programs are protected by copyright), 704 (idea-expression dichotomy applies to computer programs), 705 (elements of a computer program that are necessarily incidental to its function are unprotectable). However, the court agreed with scholarly criticism of the *Whelan* approach as overbroad and chose to articulate and apply a more detailed, practical methodology for separating unprotected idea from protected expression. *Id.* at 706.

The court in *Altai* advised district courts faced with a copyright claim relating to a computer program to first analyze the allegedly protected/infringed program and separate its constituent parts into "levels of abstraction." *Id.* at 706. The highest level is the program's overarching idea, or purpose, while the lowest levels are the source and object code. *Id.* at 707. Then, beginning with the highest level of abstraction, courts should filter out those elements of the program that are not protectable under copyright law because they are an incorporated idea, expression necessarily incidental to an idea, or covered by the copyright doctrines of public domain, merger, or scenes a faire. *Id.* at 707-10. The court emphasized that a program could have many ideas incorporated into the various levels of the program. *Id.* at 707. Finally, left with just the protectable portions of the program, a court can compare those elements that warranted protection with the allegedly infringing program to determine whether the latter had copied from the former, and whether that copying was of sufficient importance to be actionable. *Id.* at 710-11. This test has become known as the abstraction-filtration-comparison test.

The Tenth Circuit, in *Gates Rubber Co. v. Bando Chemical Indus., Ltd.*, largely adopted the *Altai* abstraction-filtration-comparison test as a concrete method for making the necessary distinction between idea and expression and applying other familiar copyright doctrines. 9 F.3d 823, 841 (10th Cir. 1993). The court recognized the criticism of *Whelan*, but opined that "when a program is understood to encompass more than one idea, the general principle of *Whelan* provides a useful means to distinguish idea from expression. At its base, *Whelan* is premised upon traditional principles of copyright law, and its conclusion that the structure of a program may be protectable is sound." *Id.* at 840. The court expanded slightly on the *Altai* test, noting that courts may find it useful to compare the allegedly infringed and infringing programs as a whole before beginning the abstraction-filtration-comparison process.

As was discussed in *Gates Rubber*, the *Altai* test encompasses the general conclusion reached in *Whelan*, and provides a concrete method for reaching those conclusions. This court agrees that the abstraction-filtration-comparison test provides a helpful structure to use in examining a computer program and determining which, if any, components of the program warrant protection under the copyright laws.

a. Abstraction

Given the complexity and evolving nature of computer technology, abstraction of a given program must be approached on a case-by-case, program-by-program basis and will often require the assistance of experts in the field. *Gates Rubber*, 9 F.3d at 834-35. "However, a computer program can often be parsed into at least six levels of generally declining abstraction: (i) the main purpose, (ii) the program structure or architecture, (iii) modules, (iv) algorithms and data structures, (v) source code, and (vi) object code." *Id.* at 835 (citation omitted); *see also Altai*, 982 F.2d at 707; *Whelan*, 797 F.2d at 1229-31. Not all computer programs will fit these general levels of abstraction. *Id.* at 835.

The main purpose of a program is a description of what the program is intended to do, or what problem it is intended to solve. *Altai*, 982 F.2d at 697; *Whelan*, 797 F.2d at 1238. The architecture or structure of a program is a description of how the program accomplishes its main purpose, i.e. its discrete functions, such as invoicing, and the order in which the program performs them. *Gates Rubber*, 9 F.3d at 835. The next level of abstraction, modules, consists of particular tasks or groupings of data within a program function. *Id.* (citation omitted). For example, the invoicing function might contain an adding module and a customer address module. Algorithms and data structures are, essentially, the specific steps or equations that make a particular module function. *Id.* Finally, the source code is the finished computer program written in a given programming language, and the object code is the source code in a binary language.

Defendants address generally each of the six levels of abstraction identified in *Gates Rubber*. Both parties discuss more specifically the compound processes, integrated square area pricing, process mapping, process management, and sequencing features of TQ Tracker.

b. Filtration

In the filtration step, the Court removes from consideration any elements of the infringed program that are not protectable under copyright law. Elements may be unprotectable because they constitute idea rather than expression, are facts or processes, are unoriginal or in the public domain, or are subject to the doctrines of merger or scenes a faire. *Control Data*, 903 F. Supp. at 1323 (citations omitted). Defendants argue that TQ Tracker's compound processes, integrated square area pricing, process mapping, process management, and sequencing are not protectable because they are "fundamental industry standards." That is, defendants allege that these features are not original because they are commonly found in computer programs in the printing industry and are, in large part, public domain. Defendants' argument is supported by their experts, who assert that these features are common to many computer programs.

Plaintiffs argue that while the idea of such features may be common or standard, Kahn's particular expression of these features is unique. For example, in his deposition, Kahn testified that although compound processes are used in many industries and programs, he invented **this** compound process. (Def. ex. 4 at 20) (emphasis added). In the same vein, Kahn asserted that "TQ Tracker handles [square area pricing] in a unique fashion," and "[i]n developing TQ Tracker [he] created an original process mapping architecture . . . defin[ing] the order in which the processes occur, and whether they are parallel or sequential in their relationship to other processes." (Kahn Declaration ¶¶ 15, 22.) Finally, Kahn maintains that the particular combination of these three features is original to TQ Tracker. (Kahn Declaration ¶¶ 7, 8.) Kahn's assertions are supported by plaintiffs' expert's conclusion that "[d]efendants copied the structure and overall organization of plaintiffs' object code directly into the form of a 746 page detailed specification" that was then converted into the Quantum MIS code. In his report and deposition testimony, plaintiffs' expert provided multiple specific examples of features within TQ Tracker that also found, in a substantially similar form, in Quantum MIS.

c. Comparison

The final step in the analysis requires comparison of the remaining protectable elements of the allegedly infringed program with the alleged infringing program to determine whether the latter was copied from the former. *Control Data*, 903 F. Supp. at 1323. The analysis is more concerned with the quality or importance of any copied elements than with the quantity of copied elements. *See Control Data*, 903 F. Supp. at 1323; *see also SAS Institute,* 605 F. Supp. at 822, 829-30 (substantial similarity existed where 44 of 186,000 lines of code were copied).

Defendants generally contend that, in the event that protectable elements of TQ Tracker remain after the filtration process, each level of the two programs are sufficiently different to indicate that Quantum MIS could not have been copied from TQ Tracker. Plaintiffs disagree, arguing that while some features of Quantum MIS expand on the equivalent features in TQ Tracker, the elements are fundamentally the same in the two programs.

d. Application

In this case, both TQ Tracker and Quantum MIS are designed to facilitate efficient management of a commercial printing operation. The main purpose of a program is almost always an idea, and thus unprotectable. *Gates Rubber*, 9 F.3d at 836 (citations omitted). However, the fact that non-protected elements are the same may indicate that protected elements are copied. *Id.* at 833 n.7. Defendants submitted evidence that even before the creation of TQ Tracker there were computer programs attempting to accomplish this goal. Thus, TQ Tracker's main purpose can obviously be accomplished in multiple ways through multiple structures and designs. The structure, design, and other elements of TQ Tracker may, therefore, be protectable expression. *See Whelan*, 797 F.2d at 1236 n.28. The parties appear to agree on the relevant elements, or levels of abstraction, of the two programs. *See* section IV(B)(2)(a), *supra*. However, there are significant differences of opinion as to whether those elements are protectable an, if so, whether they are substantially similar. The disagreements mentioned above are but a few of the specific instances where one party's expert asserts protected, unique expression and the other, with equal force, asserts the opposite. The Court is satisfied that the experts retained are all appropriately qualified, and cannot credit one over the other. In light of these significant differences, the Court is unable to say, as a matter of law, which elements of TQ Tracker merit protection under the copyright laws. Similarly, the Court is not able to determine whether any protectable elements of TQ Tracker are so dissimilar to corresponding elements in Quantum MIS to conclusively demonstrate that they were not copied from TQ Tracker. The Court therefore cannot grant defendants summary judgment on plaintiffs' copyright infringement claim.

V. BREACH OF IMPLIED COVENANT – COUNT 3

"Under Minnesota law, every contract includes an implied covenant of good faith and fair dealing requiring that one party not 'unjustifiably hinder' the other party's performance of the contract." *In re Hennepin County 1986 Recycling Bond Litig.*, 540 N.W.2d 494, 502 (Minn. 1995) (citations omitted). In other words, the covenant of good faith and fair dealing "requires a party in a contractual relationship to refrain from arbitrary and unreasonable conduct that has the effect of preventing the other party to the contract from receiving the fruits of the contract." *Erickson v. Horing*, 2002 WL 31163611, *13, (Minn. Ct. App. Oct. 1, 2002) (citation omitted). "Actions are done in 'good faith when done honestly, whether it be negligently or not.'" *Sterling Capital Advisors, Inc. v. Herzog*, 575 N.W.2d 121, 125 (Minn. Ct. App. 1998) (quoting Minn. Stat. § 520.01, subd. 6 (1996)). Conversely, actions are in bad faith when "a party's refusal to fulfill some duty or contractual obligation [is] based on an ulterior motive, not an honest mistake regarding one's rights or duties." *Id*. (citing *Lassen v. First Bank Eden Prairie*, 514 N.W.2d 831, 837 (Minn. Ct. App. 1994). Minnesota does not recognize a cause of action for breach of the implied covenant of good faith and fair dealing without an underlying breach of contract claim. *Medtronic, Inc. v. ConvaCare,* *Inc.*, 17 F.3d 252, 256 (8th Cir. 1994); *Recycling Bond Litig.*, 540 N.W.2d at 503. However, in alleging an implied covenant claim, a plaintiff "need not first establish an express breach of contract claim – indeed, a claim for breach of an implied covenant of good faith and fair dealing implicitly assumes that the parties did not expressly articulate the covenant allegedly breached." *Recycling Bond Litigation*, 540 N.W.2d at 503 (citing *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1516 (S.D.N.Y. 1989)).

In this case, plaintiffs allege that Softwares violated the "spirit and letter of the Development Agreement" by secretly developing Quantum MIS, using TQ Tracker customers to do so, and then converting TQ Tracker customers to Quantum MIS by making disparaging comments about TQ Tracker. As discussed above, plaintiffs have adequately established the existence of a contract between themselves and Softwares. Further, plaintiffs have submitted evidence demonstrating that TQ Tracker users were involved in the Quantum MIS focus group, that Softwares misrepresented Quantum MIS as an "upgrade" of TQ Tracker, and that TQ Tracker sales have declined substantially. Plaintiffs have alleged sufficient facts to permit a jury to find that defendants, in bad faith, acted to prevent plaintiffs from collecting the fruits of the Development Agreement. Summary judgment is therefore inappropriate on this count.

VI. BREACH OF FIDUCIARY DUTY – COUNT 4

A claim for breach of fiduciary duty includes four elements: (1) the existence of a duty; (2) breach of that duty; (3) causation; and (4) damages. *Conwed Corp. v. Employers*

Reinsurance Corp., 816 F. Supp. 1360, 1362 n.3 (D. Minn. 1993). Under Minnesota law, "[a] fiduciary relation exists when confidence is reposed on one side and there is resulting superiority and influence on the other." *H. Enterprises Intern. Inc. v. General Electric Capital Corp.*, 833 F. Supp. 1405, 1421 (D. Minn. 1993) (quoting *Stark v. Equitable Life Assurance Co.*, 285 N.W. 466, 470 (1939) (quotation omitted)).

A fiduciary relationship may be found to exist where one party knows or ought to know that the other is placing trust and confidence in the first party and is relying on the first party for advice and information. *W.K.T. Dist. Co. v. Sharp Electronics Co.*, 746 F.2d 1333, 1336 (8th Cir. 1984). Special circumstances sufficient to create a fiduciary relationship may also exist where confidence is placed in one party which results in superiority and influence over the other party, *id.* (citing *Midland Nat'l Bank v. Perranoski*, 299 N.W.2d 404, 413 (Minn. 1980)), where, combined with a confidential relationship, one party has greater access to facts and legal resources than the other, *May v. First Nat'l Bank of Grand Forks*, 427 N.W.2d 285, 289 (Minn. Ct. App. 1988), or where there is both a disparity of business experience and the party with greater experience has invited the other's confidence, *Murphy v. Country House, Inc.*, 240 N.W.2d 507, 512 (Minn. 1976).

Plaintiffs claim that a fiduciary duty arose between themselves and Softwares because Softwares was the exclusive distributor of TQ Tracker, and plaintiffs trusted and relied on Softwares to honestly and vigorously promote, support, and sell the TQ Tracker software. The Court disagrees. Plaintiffs and defendants entered into a negotiated business relationship, governed by multiple agreements and licenses. The Development

Agreement provided for minimum payments to plaintiffs, reserved proprietary rights in TQ Tracker to plaintiffs, and dictated steps to take to terminate the relationship. There is not a significant disparity of business experience between the two parties, both of which are small businesses. Although defendants were responsible for marketing TQ Tracker, plaintiffs remained closely involved in its ongoing development and maintenance and were thus in a position to regularly monitor defendants' activities. The Court finds that plaintiffs have not demonstrated any special circumstances distinguishing this case from an ordinary producer-distributor relationship. The Court therefore holds that a jury could not find that a fiduciary relationship existed between plaintiffs and defendants in this case. Accordingly, the Court grants defendants' motion for summary judgment on this claim.

VII. TRADE SECRET MISAPPROPRIATION – COUNT 5

To make out a claim of misappropriation of a trade secret, a plaintiff must show that (1) a trade secret existed, (2) the defendant acquired the trade secret through a confidential relationship, and (3) the defendant used or disclosed the trade secret. *Electro-Craft Corp. v. Controlled Motion, Inc.*, 332 N.W.2d 890, 897 (Minn. 1983); *Jostens, Inc. v. National Computer Sys., Inc.*, 318 N.W.2d 691, 701 (Minn. 1982); *New Leaf Designs, L.L.C. v. BestBins Corp.*, 168 F. Supp. 2d 1039, 1043 (D. Minn. 2001).

Minnesota law defines a "trade secret" as "information, including a formula, pattern, compilation, program, device, method, technique, or process, that: (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy." Minn. Stat. § 325C.01, subd. 5 (2000). "Misappropriation" is defined as the "disclosure or use of a trade secret of another without express or implied consent of a person who . . . at the time of disclosure or use, knew or had reason to know that his knowledge of the trade secret was . . . acquired under circumstances giving rise to a duty to maintain its secrecy or limit its use . . ." Minn. Stat. § 325C.01, subd. 3(ii)(B)(II). Computer software such as TQ Tracker may be entitled to trade secret protection. *Aries Info. Sys., Inc. v. Pacific Mgmt. Sys. Corp.*, 366 N.W.2d 366, 368 (Minn. Ct. App. 1985). However, "matters of general knowledge within an industry may not be classified as trade secrets or confidential information entitled to protection." *Cherne Indus., Inc. v. Grounds & Assocs., Inc.*, 278 N.W.2d 81, 90 (Minn. 1979) (quotation and citation omitted).

Plaintiffs claim that defendants misappropriated the TQ Tracker source code and feature set as well as four other trade secrets: (1) detailed explanations of the logical workings of the feature sets of TQ Tracker; (2) specific results of empirical studies to determine which feature sets are appropriate to resolve given real-world problems; (3) best business practices incorporated into the TQ Tracker software; and (4) field discussions about the theory behind the feature sets and resolutions of the problems, how end-users perceive issues and how to match the program to end-users expectations. Defendants assert that the information i-Systems seeks to protect does not qualify as trade secrets.

The Court is satisfied that TQ Tracker as a whole and the specific pieces of related information identified by plaintiffs qualify as trade secrets. TQ Tracker derives economic value from being generally unknown and unavailable. Indeed, if either the program or the various pieces of information were readily available from multiple sources, the market price of the program would undoubtedly decrease because competing programs could be created and marketed more easily and more cheaply. Further, there is evidence that plaintiffs took reasonable steps to protect this information by using password protected downloads and making any use of the program subject to license agreements.

The Court is also satisfied that, for purposes of summary judgment, defendants both had access to and may have improperly used the information. As the sole distributors and, essentially, development partners of TQ Tracker, defendants had a confidential relationship with plaintiffs that permitted defendants access to plaintiffs' alleged trade secrets. Plaintiffs assert that defendants used these secrets in the development and marketing of Quantum MIS. As discussed more extensively in section III (copyright), plaintiffs have presented sufficient evidence for a jury to conclude that defendants used their knowledge of TQ Tracker and their experience marketing TQ Tracker to create and market Quantum MIS. Thus, as with the copyright claim, summary judgment is inappropriate with respect to this claim.

VIII. FRAUDULENT TRANSFER – COUNT 6

Plaintiffs assert that defendants transferred Softwares' technology, know-how and software to Quantum, LLC in an attempt to hinder, delay, or defraud plaintiffs. Minnesota Statute §§ 513.41-51 prohibit debtors from transferring property with the intent to hinder, delay, or defraud creditors, or without receiving a reasonably equivalent value in exchange for the transfer. Minn. Stat. § 513.44(a)(1), (2); *In re Minn. Breast Implant Litigation*, 36 F. Supp. 2d 863, 880 (D. Minn. 1998). In determining whether a fraudulent transfer has occurred, a court may consider whether the transfer was made to avoid future liability. *Breast Implant Litigation*, 36 F. Supp. 2d at 880. In other words, the Court may consider whether "before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit." *Id.* (citing Minn. Stat. § 513.44(b)(4)).

In this case, the Court finds no evidence that Softwares' transfer of assets to Quantum LLC was intended to hinder, delay, or defraud i-Systems, or more specifically to avoid any liability that might accrue due to this action. Softwares, Quantum, and CHOF all remain defendants in this case. There is no indication that, should plaintiffs prevail on their claims, they will be unable to recover from defendants. Summary judgment is therefore granted to defendants on this claim.

IX. DECEPTIVE TRADE PRACTICES – COUNT 10

Plaintiffs allege that defendants violated the Minnesota Deceptive Trade Practices Act. Minn. Stat. § 325D.44. A claim under Minnesota Statute § 325D.44 requires the same analysis as does the federal Lanham Act. *Group Health Plan, Inc. v. Philip Morris, Inc.*, 68 F. Supp. 2d 1064, 1069-70 (D. Minn. 1999) (citing *Medical Graphics Corp. v. SensorMedics Corp.*, 872 F. Supp. 643, 650 (D. Minn. 1994)). Thus, plaintiffs must establish that (1) Softwares made false or misleading statements in its commercial advertising or promotion; (2) those statements actually deceived or have the tendency to deceive a substantial segment of their audience; (3) such deception is likely to influence buying decisions; and (4) plaintiffs have been or are likely to be injured as a direct result of those activities. *Id*. The statute permits a plaintiff to seek injunctive relief, but not monetary damages. *Dennis Simons D.D.S., P.A. v. Modern Aero, Inc.*, 603 N.W.2d 336, 339 (Minn. Ct. App. 1999).

Plaintiffs maintain that defendants mailed announcements to TQ Tracker customers and represented at trade fairs that Quantum MIS was an upgrade of TQ Tracker, and that the previous version of TQ Tracker was broken. Plaintiffs have submitted evidence of at least one such advertisement. Plaintiffs have also submitted evidence that defendants represented to TQ Tracker users in the Quantum MIS focus group that TQ Tracker was unstable and had speed issues, among other things. Defendants contend that plaintiffs have failed to show that these alleged statements were false or misleading. The Court disagrees. Plaintiffs clearly maintain that TQ Tracker is a functioning product, and that Quantum MIS is a competing product copied, in large part, from TQ Tracker. Whether defendants' version or plaintiffs' version is true is a classic question of fact.

Defendants also contend that plaintiffs have not shown they were damaged in any way. There is evidence that TQ Tracker's sales have decreased substantially since defendants ceased marketing TQ Tracker and began developing and marketing Quantum MIS. This is sufficient evidence from which to conclude that plaintiffs were harmed by defendants' statements to current and potential TQ Tracker customers. Plaintiffs explicitly seek injunctive relief. Plaintiffs have adequately pled and supported their claim for violation of the Minnesota Deceptive Trade Practices Act, and the Court therefore will not grant defendants' motion for summary judgment on this claim.

X. DISREGARD OF CORPORATE ENTITY – COUNT 8

There is a general presumption that "absent fraud or bad faith, a corporation will not be held liable for the acts of its subsidiaries." *Assoc. of Mill & Elevator Ins. Co. v. Barzen Int'l, Inc.*, 553 N.W.2d 446, 449 (Minn. Ct. App. 1996); *United States v. Bestfoods*, 524 U.S. 51, 61 (1998). Nevertheless, "[t]he law will not recognize corporate formalities used to circumvent a statutory policy or to violate a law." *United States v. Advance Machine Co.*, 547 F. Supp. 1085, 1093 (D. Minn. 1982) (citation omitted). Minnesota recognizes the "alter ego" doctrine, also known as "piercing the corporate veil," to impose liability on an individual shareholder or parent corporation that has used a corporate form to evade liability. *See Victoria Elevator Co. of Mpls. v. Meriden Grain Co., Inc.*, 283 N.W.2d 509, 512 (Minn. 1979); *Mill & Elevator Ins.*, 553 N.W.2d at 449.

In order to prevail under this theory, a plaintiff must meet both prongs of the test established by the Minnesota Supreme Court in *Victoria Elevator*, 283 N.W.2d 509

(Minn. 1979). "The first prong focuses on the shareholder's relationship to the corporation." *Barton v. Moore*, 558 N.W.2d 746, 749 (Minn. 1997). Factors including "insufficient capitalization for purposes of corporate undertaking, failure to observe corporate formalities, non-payment of dividends, insolvency of debtor corporation at time of transaction in question, siphoning of funds by dominant shareholder, non-function of other officers and directors, absence of corporate records and existence of corporation as merely façade for individual dealings" are relevant to this assessment. *Victoria Elevator*, 283 N.W.2d at 512. The second prong requires showing that injustice or fundamental unfairness will result from permitting defendants to rely on the corporate veil. *Id.*; *Minnesota Power v. Armco, Inc.*, 937 F.2d 1363, 1367 (8th Cir. 1991).

CHOF was the sole shareholder of Softwares, Inc. and is the sole shareholder of both Softwares, LLC and Quantum, LLC. CHOF capitalized Softwares, LLC by transferring its interest in Softwares, Inc. to Softwares, LLC. Quantum, LLC was capitalized by a $10 payment from CHOF and the transfer of the Quantum MIS product from Softwares, LLC to Quantum, LLC. Three individuals are largely responsible for CHOF, Softwares and Quantum, and many of the employees of Quantum also work for Softwares (and vice versa) and are compensated through CHOF. The person in charge of accounting at Softwares and Quantum is also a board member of CHOF. He testified that funds are regularly moved between CHOF owned companies to satisfy debts at the various companies. Funds from other CHOF entities were used to pay Softwares' outstanding debt to the developer of Quantum MIS. These transfers occur without formal agreements, debt collection practices, or enforcement between the various CHOF companies.

The Court notes that Softwares, LLC is participating in this action on behalf of its corporate predecessor, Softwares, Inc., and that Softwares, LLC is covered by a general liability insurance policy. Nevertheless, the Court is satisfied that given CHOF's intimate involvement in both Softwares and Quantum and the ease and frequency with which assets appear to be transferred between CHOF's subsidiaries, allowing CHOF and Quantum to escape liability because each is technically a separate business from Softwares would permit them an advantage they do not merit. Thus, the Court will not grant defendants' motion for summary judgment on this claim.

XI. CONSPIRACY – COUNT 9

"[A] conspiracy is a combination of persons to accomplish an unlawful purpose or to accomplish a lawful purpose by unlawful means." *Bloom v. Hennepin County*, 783 F. Supp. 418, 446 (D. Minn. 1992). Under Minnesota law, a corporation cannot conspire with itself. *Stock v. Heiner*, 696 F. Supp. 1253, 1262 (D. Minn. 1988) (applying Minnesota law to a claim alleging conspiracy to defame). Similarly, a wholly owned subsidiary cannot conspire with its parent corporation. *See Copperweld Corp. v. Independent Tube Corp.*, 467 U.S. 752, 770-73 (1984) (Sherman Act); *Palm Beach Polo, Inc. v. Dickinson Financial Corp.*, 221 F.3d 1343 (Table) (8th Cir. 2000) (parent and subsidiary cannot conspire for tortious interference with contract); *Fogie v. THORN*

Americas, Inc., 190 F.3d 889 (8th Cir. 1999) (parent and subsidiary cannot conspire to violate RICO Act).

In *Copperweld*, the Supreme Court stated that "[i]n any conspiracy, two or more entities that previously pursued their own interests separately are combining to act as one for their common benefit." *Copperweld*, 467 U.S. at 769. The Court determined that an alleged conspiracy between a parent and a subsidiary cannot exist because "[a] parent and its wholly owned subsidiary have a complete unity of interest. Their objectives are common, not disparate; their general corporate actions are guided or determined not by two separate corporate consciousnesses, but one." *Id*. at 771.

As discussed in section X., Softwares and Quantum are both wholly owned subsidiaries of CHOF. All three are controlled and managed by the same small group of people. All share the goal of supporting CHOF and its membership. Thus, as in *Copperweld*, the Court finds that a conspiracy cannot, as a matter of law, exist between CHOF, Softwares, and Quantum and this claim will be dismissed.

XII. BIFURCATION

Federal Rule of Civil Procedure 42(b) permits the Court to bifurcate or otherwise split a trial "in furtherance of convenience or in order to avoid prejudice, or when separate trials will be conducive to expedition and economy." Quantum and CHOF request that any trial of this action be split into two sections – the first involving all of plaintiff's claims except the alter ego claim, and the second involving the alter ego claim. They assert that "if plaintiffs do not prevail on their substantive claims at trial, the alter ego issues would become moot, thus shortening the length of the trial and minimizing the evidence that the jury has to digest at one time." i-Systems opposes bifurcation, pointing out that all but the breach of contract claim are asserted against all three defendants.

The Court finds that bifurcation is not appropriate. Initially, the Court does not agree that bifurcation would further judicial economy and convenience. As discussed in section X, all defendants are controlled and managed by the same small group of people. These people will undoubtedly be called as witnesses regarding the substantive claims and, because of their involvement in all companies, the alter ego claim. Maintaining all of the claims in one action allows these people to testify once rather than twice. Even if they spend slightly longer testifying about the substantive claims and the alter ego claim, hearing from each person once seems more efficient and practical than possibly hearing from each witness twice in two separate proceedings.

Defendants also assert that they could be prejudiced by a single trial because the jury may have difficulty deciphering liability and damages issues from the corporate organization questions. The Court is confident that any potential confusion can be cured through the jury instructions and verdict form. The Court therefore denies defendants' motion to bifurcate.

This case will be placed on the Court's next trial calendar.

ORDER

Based on the foregoing, all the records, files, and proceedings herein, **IT IS HEREBY ORDERED** that:

1. Defendants' Motion for Summary Judgment [Docket No. 68] is **GRANTED in part and DENIED in part.**

   a. Defendants' motion is **GRANTED** as to counts 4 (breach of fiduciary duty), 6 (fraudulent transfer), 7 (Minnesota Consumer Fraud Act) and 9 (conspiracy) of the Complaint. Counts 4, 6, 7, and 9 of plaintiffs' Amended Complaint [Docket No. 12] are **DISMISSED with prejudice**;

   b. Defendants' motion is **DENIED** in all other respects.

2. Defendants Quantum Management LLC's and Christ's Household of Faith, Inc.'s Motion for Bifurcation [Docket No. 56] is **DENIED**.

DATED: March 29, 2004
at Minneapolis, Minnesota.

s/ John R. Tunheim
JOHN R. TUNHEIM
United States District Judge